

REVENUE

ISSUES FOR HEARING

December 2015 Consensus Revenue Estimate

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Summary.

- The Consensus Revenue Estimating Group (CREG) comprised of the Legislative Finance Committee, Department of Finance and Administration, and the Taxation and Revenue Department, met and reached consensus on the revenue estimates presented herein this brief.
- Unaudited preliminary FY15 recurring revenue is now \$6.2 billion, \$32.1 million less than the August 2015 estimate. Table 1 presents a reconciliation of recurring revenues through the revenue estimating cycle.
- Compared with the August 2015 forecast, the FY16 recurring revenue estimate was revised downward by \$82.7 million to \$6.17 billion and the FY17 revenue estimate was revised downward by \$61.7 million to \$6.47 billion. Attachment 1 shows general fund revenue revisions from August 2015 to December 2015.
- Attachment 2 shows the general fund financial summary. Preliminary FY15-ending reserve balances are \$612.0 million, or 9.9 percent of recurring appropriations. Projected FY16-ending reserve balances are \$506.0 million, or 8.1 percent of recurring appropriations.
- “New Money” in FY17, defined as FY17 projected recurring revenue less FY16 recurring appropriations, is projected to be \$231.7 million, or 3.7 percent of FY16 appropriations. This is a decrease from the August consensus which stated \$293 million.
- The forecast presents several downside risks with uncertainties including:
 - oil and gas prices remain at current levels (see charts, page 4)
 - weak Q1 FY16 revenues results continue (see attachment 3)
 - tax credits continue at high Q1 FY16 pace
 - job growth remaining within range of negative growth
 - e-commerce sales weaken gross receipts tax

Table 1

December 2015 Consensus General Fund Recurring Revenue Outlook

(in millions of dollars)

	<u>FY15</u>	<u>FY16</u>	<u>FY17</u>	<u>FY18</u>
August 2015 Consensus	\$6,227	\$6,248	\$6,528	\$6,833
December 2015 Adjustments	(\$32)	(\$83)	(\$62)	(\$38)
December 2015 Consensus	\$6,195	\$6,165	\$6,466	\$6,795
Annual amount change	\$150	(\$30)	\$301	\$329
Annual percent change	2.5%	(<1%)	4.9%	5.1%

The US and NM Economic Forecast. The consensus revenue estimating group uses two different forecasting services in developing the economic assumptions on which the forecast is based. The Legislative Finance Committee (LFC) and the Taxation and Revenue Department (TRD) rely on New Mexico forecasts produced by UNM’s Bureau of Business and Economic Research (BBER). BBER, in turn, relies on a national forecast produced by IHS Global Insight. The Department of Finance and Administration (DFA) uses Moody’s Analytics for its national and state forecasts. Selected economic indicators from the forecasts are presented in Attachment 4.

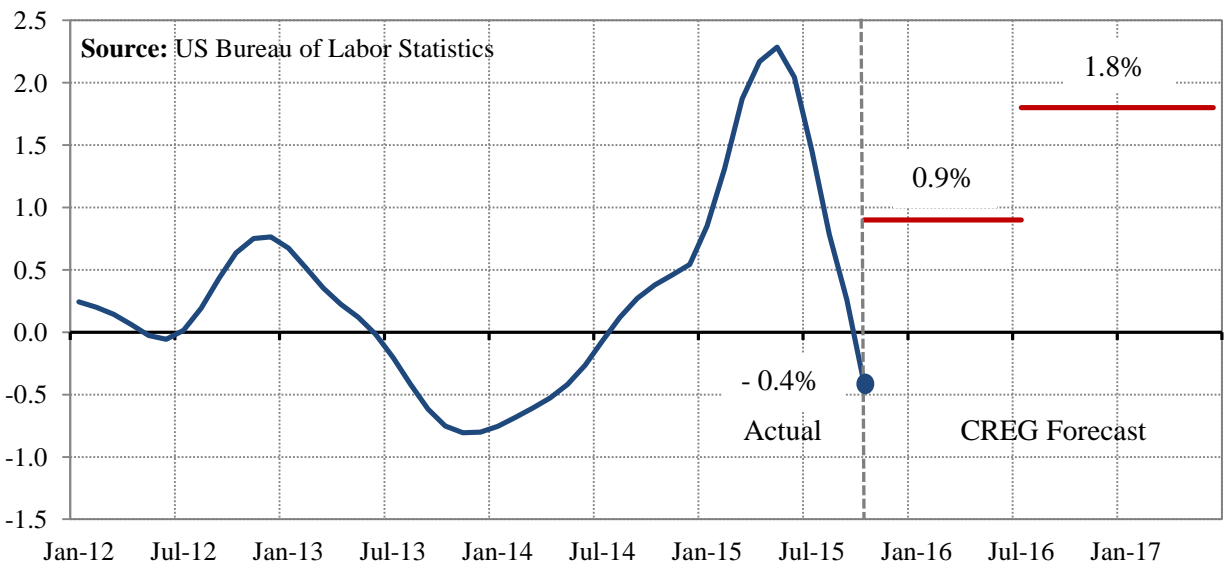
United States. At the national level, IHS forecasts in the calendar years, moderate growth at 2.9 percent in 2016 and 3.0 percent in 2017 and averaging 2.5 percent from 2018 through 2020. IHS forecasts employment will expand by 1.5 percent in 2016, then slowly decline 1.3 percent in 2017, and 1.2 percent in 2018. These growth rates are slightly downward from the previous IHS forecast, but they still contribute to a flat unemployment rate of 5.0 percent. Weak payroll gains and stagnant wages contribute to a mediocre growth forecast.

IHS expects the Federal Reserve to raise interest rates in December by a quarter of a percent. The move is bolstered by slightly positive economic data. CPI inflation has continued to move sideways during the year as oil continues to fall to lower price levels than seen previously.

The national employment picture improved over the last year. Approximately 211 thousand jobs were added during November following a 298,000 gain in October. The boost in employment may be attributed to construction and retail hiring. The seasonally adjusted unemployment rate of 5.0 percent is down, in large part reflecting a drop in the labor force participation rate which fell to 62.4, its lowest level since October 1977.

New Mexico. The state of New Mexico has lagged the U.S. in the post-recession recovery. A persistently weak labor market in combination with slow growth of household incomes drags the advancement of the New Mexico economy. Employment in the state remains below the pre-recession peak, unlike surrounding states which have substantially recovered. Year over year as of October 2015 the Department of Workforce Solutions reports the state added 2,800 jobs or 0.3 percent. For the same month however, the US Bureau of Labor Statistics reports that the state lost 3,500 jobs, or 0.4 percent. Both reports are well below the forecast.

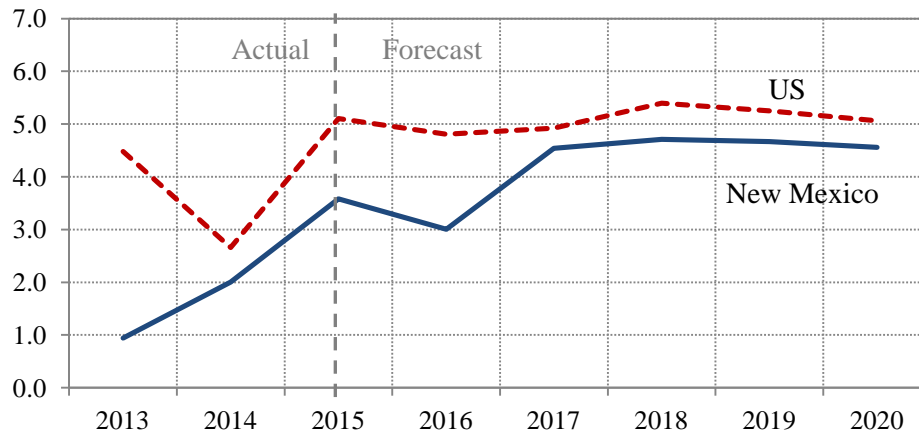
NM Employment, Seasonally-Adjusted Annual Growth (%)



Note: "CREG forecast" is the average of BBER and Moody's forecast services.

Additional data suggests that earlier evidence of NM job growth was overly optimistic, and the contraction of the economy, notably in manufacturing and mining sectors, contributes to a delayed move towards positive growth. BBER notes the weak labor market continues to contribute to a slowdown in personal income growth within New Mexico. A positive note may be attributed to the healthcare subsector. Healthcare employment, funded by the Medicaid expansion, grew substantially in New Mexico, and is expected to account for more than one-quarter of all new jobs created in the next five years.

New Mexico vs. US Wages & Salary Growth (% , FY)



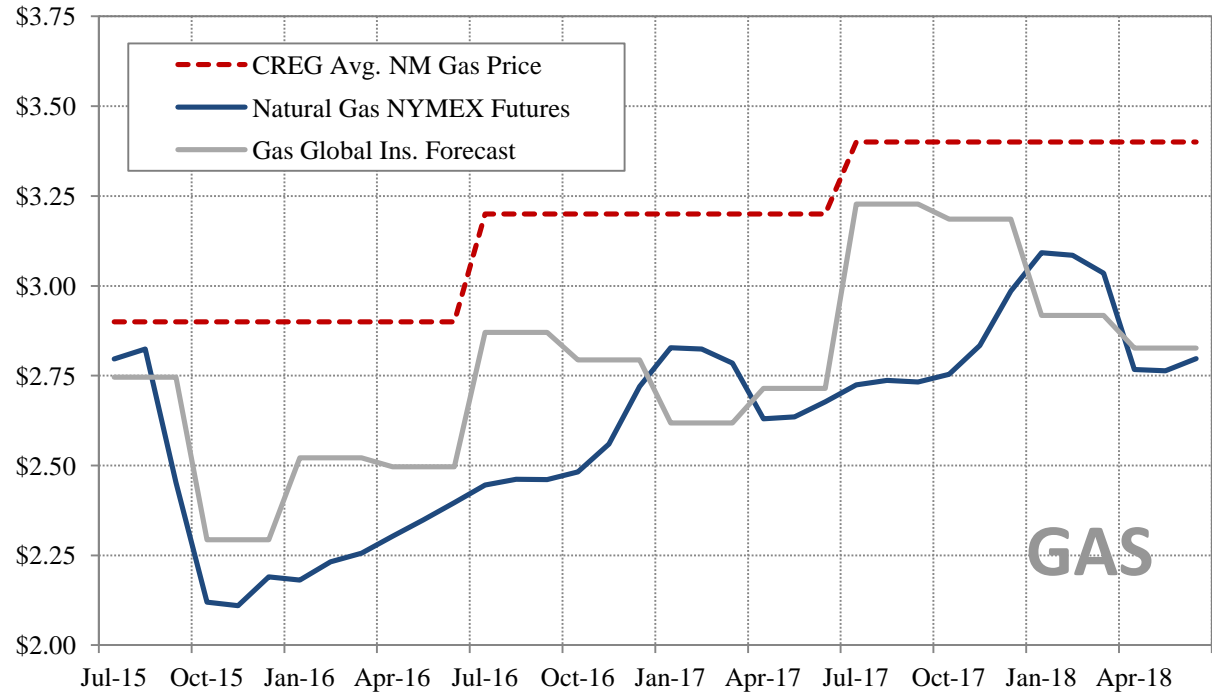
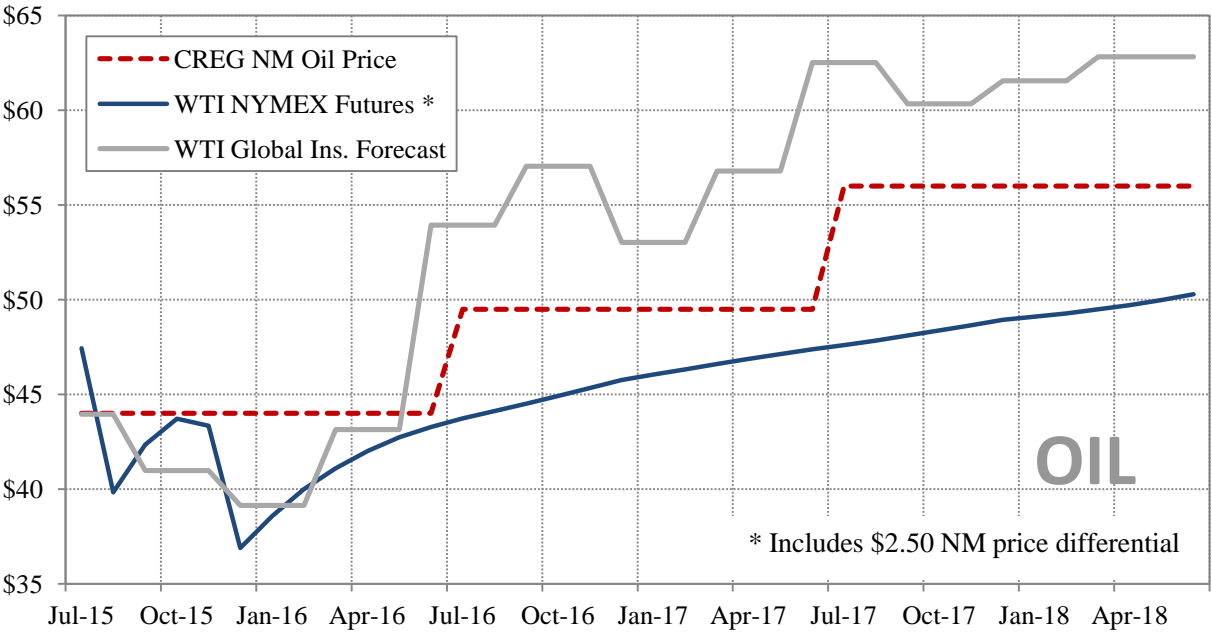
Oil & Gas. The CREG price forecast is above current market prices. NYMEX January 2016 oil and gas prices are \$40.14 / bbl and \$2.18 / MMBtu respectively. In comparison, IHS Global Insight expects prices to average \$55.92 / bbl and \$2.75 / MMBtu in FY17. The CREG forecast is a combination of both market and Global Insight forecasts. CREG expects prices to average \$49 / bbl and \$3.20 / MMBtu in FY17.

Since 2014, global demand for crude oil has not been able to absorb surging supply. The imbalance has sent energy prices crashing, with the oversupply expected to keep prices low through the end of 2016. Furthermore, the growing levels of crude oil in storage will slow any price recovery. The EIA reports that the US has reached levels of oil in storage that have not been seen in 80 years (see figures, page 5).

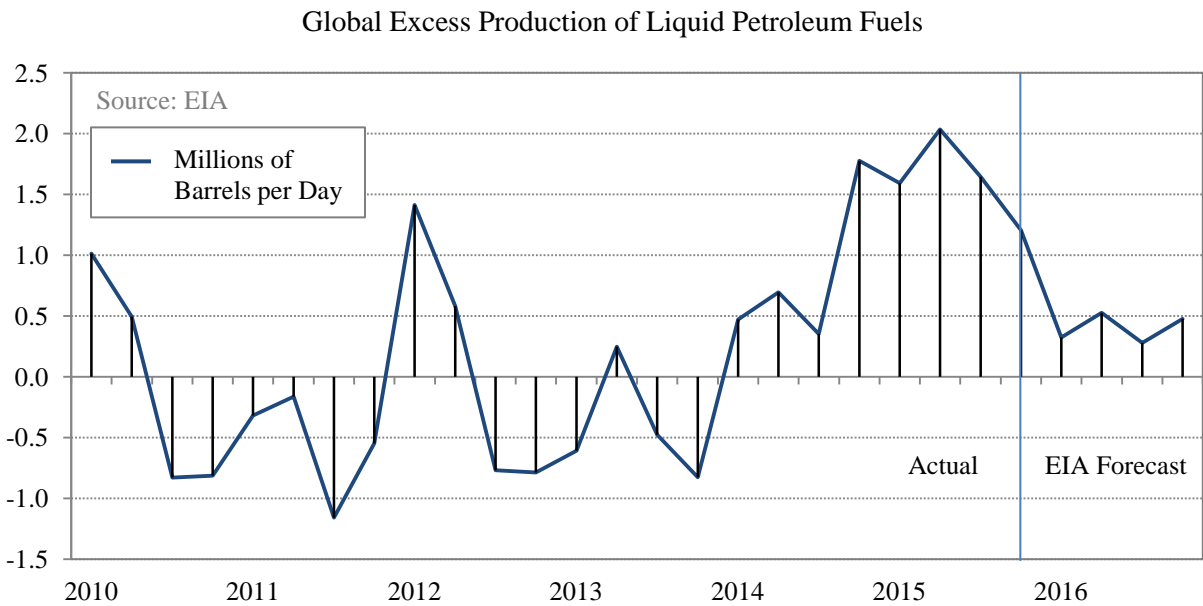
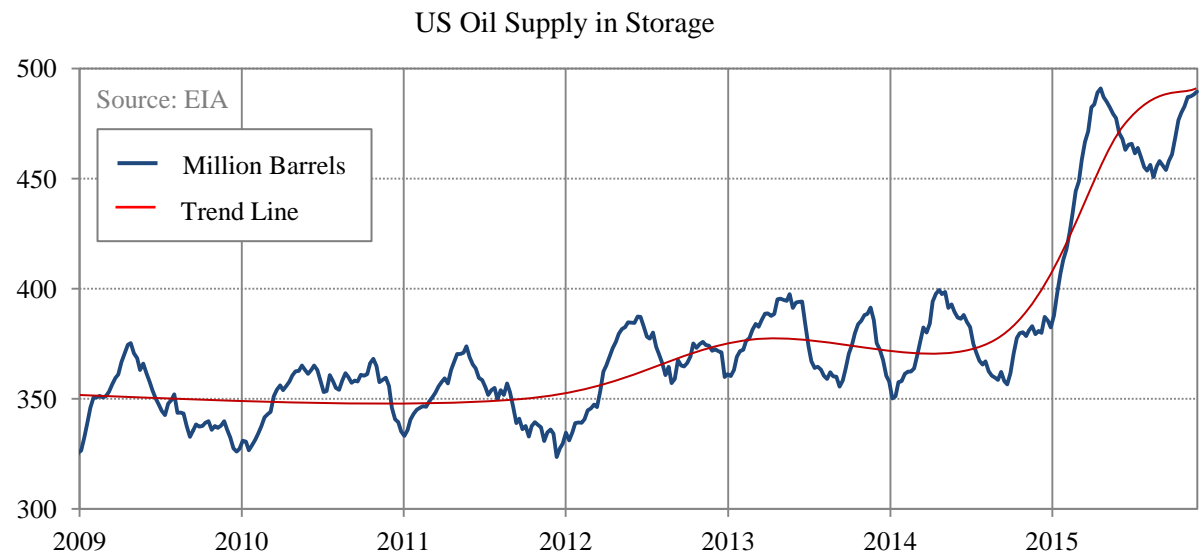
If market prices do not recover as expected, general fund revenue may decrease by \$100 million or more in FY16 and FY17. It is not known whether increased production in the Permian basin will be sufficient to eliminate this outstanding price risk. In FY15 oil production grew 25%. Production is now more than double the level that prevailed over the last 30 years. The forecast assumes oil production growth continues albeit at 6 percent in FY16 and 3 percent in FY17.

The gas price forecast represents an increase of more than 40 percent over the January 2016 spot price. As a rule of thumb, a \$1 change in the price of oil—sustained over the course of a full fiscal year—leads to a \$10 million change in general fund revenue. For natural gas, a \$0.10 change in price over a fiscal year leads to \$7 to \$8 million change in general fund revenue.

Traditionally, NM crude oil has been priced lower than standard WTI by a differential of \$5.00. According to well operators in the state, this differential has decreased to a range of \$2 to \$3, which increases general fund revenue. On the other hand, the liquids premium for NM has evaporated and is expected to remain at (or below) zero. In a low price environment, the natural gas liquids are no longer an attractive alternative to crude oil.

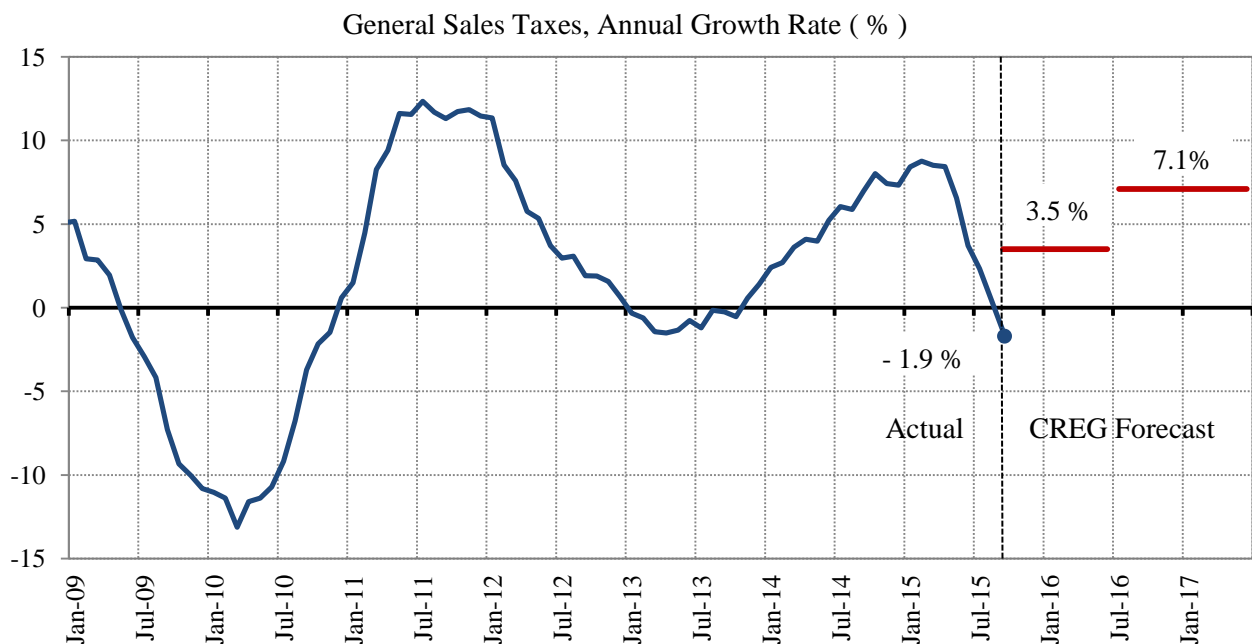


Too Much Supply, Not Enough Demand:



Revenue Highlights.

- Gross Receipts Tax.** Partially the result of increased taxpayer compliance, revenue from the gross receipts tax increased 5.2 percent in FY15 over FY14. As observed in FY15, the level of deductions taken against GRT liabilities has decreased in the last few quarters of data – a possible indication of audit results. This is an upside risk to the consensus forecast if the recent increase in taxpayer compliance is sustained into the out years. However, the first quarter of FY 16 resulted in negative revenue year-on-year, partly due to the substantial drop in oil and gas prices with a concomitant decrease in well drilling and well service activity, and a drop in wages and salaries attributed to layoffs in the mining industry. In addition, settlements of high-wage job credits caused a drop in revenues expected to be in excess of the percentage drop in taxable gross receipts for the quarter. GRT revenue is expected to increase 4 percent in FY 16 and 7.9 percent in FY 17. In FY16 the estimated rate assumes lower gas and oil prices. The CREG anticipates the federal budget deal will add about 1 percent to FY 17 above the amount calculated in the base models.
- The last 12-months of general sales taxes (GRT and compensating tax) are 1.9 percent (\$40.4 million) below the same period of the previous year. This trend may have not bottomed out.



- Compensating Tax.** Oil and gas equipment account for a large share of compensating tax revenue. In the first three months of FY16, revenue from compensating tax decreased \$17.1 million (61.3 percent) over the same period of the prior year. The forecast is a 9 percent decline in FY16 and flat in FY17 due to the continuing weakness in purchases and capital expenditures of the mining sector.
- Personal Income Tax.** FY15 saw increased activity in personal income tax (PIT) revenue from growth in tourism and professional services. Withholding is an area of real growth in the economy and a strong indicator of the direction of movement. Employment growth throughout the country has led to difficulty in hiring qualified staff. Income is on the upswing nationally as employers are offering bonuses to retain experienced staff and to take on more qualified employees. PIT revenue is expected to grow 4.6 percent in FY16, and 3.99 percent in FY17, which are reasonably in tandem with personal income and wages and salaries forecasts.

- *Corporate Income Tax.* House Bill 641 (Laws 2013, Ch. 160) made significant changes to the corporate income tax code. The fiscal impact report (FIR) for HB 641 initially estimated that the changes would result in a revenue loss of \$7.2 million in FY14. However, actual CIT revenue in that fiscal year missed its forecast by more than the estimated \$7.2 million cost. In FY14, net CIT revenue was subject to a six-month forecast error of \$82.2 million (41.8 percent), and an 18-month error of \$143.4 million (72.2 percent).

Due to strengthening economic fundamentals in the state during FY14, the source of the error remains unclear. Analyzing actual FY14 taxpayer data would provide a more accurate estimate of the bill's impact on CIT collections; however, TRD notes it will not have this data until 2016. Due to confidentiality restrictions, access to taxpayer-level data and further analysis is limited to TRD. Due to the volatile nature of CIT collections, it is not yet possible to disaggregate this error and attribute it to either forecasting error or to an error in the estimated revenue impact of HB 641. Keeping this uncertainty in mind, CREG anticipates that CIT revenue, net of all credits, will drop 14.4 percent in FY 16 but stay flat in FY 17. Continued tax credits in FY17 are expected to reduce CIT payments approximately \$30 million in FY17 so the estimate in effect assumes an increase in profitability.

- *Interest Earnings.* The Federal Reserve is expected to raise short-term interest rates in December. Earnings on state balances held at the State Treasurer's Office are directly related to the yield on short-term, fixed-income instruments.
- Revenues associated with the permanent funds will see slow movement in FY16. Distributions are based on a rolling average of the last 5 calendar years' market value for the respective funds. Due to strong capital gains in the last few years, growth is expected at 7 percent in FY16. But, pursuant to the Constitution of New Mexico, the rate of distribution from the Land Grant Permanent Fund (LGPF) to beneficiaries is scheduled to decrease from 5.5 percent of the fund's market value in FY16 to 5.0 percent in FY17. The permanent funds will be approximately flat.
- *Insurance Premiums Tax.* The enrollment take-up rate of Medicaid and the ACA exchange remains uncertain. Various estimates exist for exchange enrollment, and the newness of the program provides minimal information to date. The rate at which members of the New Mexico Medical Insurance Pool transition to either Medicaid or the exchange has thus far been rather high. The anticipated rate at which members will continue to transition out of the pool will be lower in 2016 as the NMMIP Board will not take coordinated action to move members out of the pool until 2017. The resulting uncertainty in NMMIP assessments to insurers affects general fund revenue through the NMMIP credit.
- *Federal Mineral Leasing.* The shares of FML are growing at a steady level. The shift towards drilling on federal lands has expanded dramatically. Over the last two years, nearly 60 percent of drilling activity has shifted to federal land. As oil companies complete their price and volume valuation activity for the calendar year in response to commodity price decreases, a more complete picture of leasing and royalty activity will come to light towards the end of this year. The oil and gas sector has been impacted by broad pricing volatility over the last year, enhanced drilling techniques have continued, pushing the oil supply to record levels. This combination contributes to a forecast presenting a slowdown in FML activities in FY16 and stabilizing beyond FY17.

December 2015 - CREG Gross Receipts Tax Forecast						
	FY15	FY16	FY17	FY18	FY19	FY20
DFA	\$2,135.0	\$2,190.0	\$2,356.0	\$2,458.0	\$2,622.0	\$2,747.0
LFC	\$2,095.0	\$2,122.0	\$2,261.0	\$2,463.0	\$2,657.0	\$2,850.0
TRD	\$2,095.2	\$2,152.0	\$2,258.0	\$2,366.0	\$2,492.0	\$2,619.0
Average:	\$2,095.0	\$2,154.7	\$2,291.7	\$2,429.0	\$2,590.3	\$2,738.7
CREG GRT:	\$2,095.00	\$2,154.7	\$2,291.7	\$2,429.0	\$2,590.3	\$2,738.7
Growth %:	5.2%	2.8%	6.4%	6.0%	6.6%	5.7%
DFA Growth	7.2%	2.6%	7.6%	4.3%	6.7%	4.8%
LFC Growth	5.2%	1.3%	6.6%	8.9%	7.9%	7.3%
TRD Growth	5.2%	2.7%	4.9%	4.8%	5.3%	5.1%
Deductions:						
Manufacturing & Construction	\$0.0	-\$5.7	-\$12.2	-\$19.4	-\$20.7	-\$21.9
HB581, SB302, DOD, Border Zone		-\$1.5	-\$2.1	-\$2.7	-\$3.3	-\$3.4
Gasoline Add Factor		\$15.0				
Fed Spending Add Factor			\$22.0	\$13.0		
Medicaid Add Factor	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Subtotal:	\$0.0	\$7.8	\$7.7	-\$9.1	-\$23.9	-\$25.3
Consensus Net GRT:	\$2,095.0	\$2,162.4	\$2,299.4	\$2,419.9	\$2,566.4	\$2,713.4
Aug 15 Consensus	5.2%	3.2%	6.3%	5.2%	6.1%	5.7%
Diff	\$2,129.9	\$2,233.9	\$2,331.7	\$2,424.5	\$2,525.8	\$2,630.0
	-\$34.9	-\$71.5	-\$32.3	-\$4.6	\$40.6	\$83.4
	-1.7%	-3.3%	-1.4%	-0.2%	1.6%	3.1%

Financial Summary. FY15 ending general fund balances are shown at \$612 million. This amount reflects a \$101.7 million contingent liability change in FY13 and FY14 related to the cash reconciliation. It is expected that almost all of this change will be reversed in the FY15 audit expected to be released in the next month.

Revenue Risks.

- *Internet Sales.* CREG analysts discussed whether the internet buying (e-commerce) patterns were sufficiently accounted for in the models. A substantial amount of internet consumer (as opposed to business-to-business) sales may have been a conversion from former retail and offline sales. This would result in no net change in Taxable Gross Receipts. Many 'bricks-and-mortar' retail companies, including WalMart, Target, Home Depot and Lowes have significantly increased their internet retail access. The advantage is a vastly expanded inventory available through the internet. The internet sales of companies that have a 'nexus' or a physical presence with the state are taxable. Anecdote implies that the pace of internet sales may have accelerated – particularly through the critical holiday shopping period starting on Thanksgiving day.
- *Phase Out of the Hold Harmless.* HB-641 passed in the 2013 session (Laws 2013, Chapter 160) provided for a phased reduction in both the food and medical hold harmless payments to counties and municipalities. Beginning with July sales, with revenues distributed to the counties and municipalities in September, a reduction of 6% (100% - 94%) should have been made in both the food and medical hold harmless amounts. Municipalities with populations less than 10,000 and counties with populations less than 48,000 are scheduled to retain the full amount of the hold harmless distributions until each county or municipality exceeds the population threshold. However, based on a one-month sample from July 2008, 86% of medical deductions are from qualifying locations and approximately 80% of food is purchased in qualifying locations. The final FIR for HB-641 estimated the FY16 revenues from the combined total of

food and medical hold harmless phase-out at \$7,726.3 thousand and the FY17 revenues at \$15,737.6. Based on the three months of FY 16, the anticipated total increase in general fund revenue will be about \$3,820 thousand, not \$7,726.3 as shown in the 2013 FIR. This is approximately 50% of the amount originally estimated. If this pattern persists, it is a -\$3 million downside risk to revenues in FY16 and a -\$6 million risk in FY17.

Revenue Estimating Error. Economic downturns are associated with forecasts that overestimate revenue. On average however, the consensus forecast underestimates recurring revenue by 4 percent, 18 months in advance, and by 2 percent, 6 months in advance. Attachment 5 illustrates forecast errors in the consensus general fund revenue estimates over the last 10 years.

Tax Expenditures and Tax Law Changes. The potential for increases in the cost of tax credits is a risk to state revenues. In recent years, several tax expenditures for economic development have had a larger fiscal impact than initially estimated, contributing to revenue estimating error. In some cases the revenue impacts have significantly exceeded initial estimates, requiring changes in statute to curb the impact.

To illustrate, the table below highlights the revenue impacts of the corporate income tax rate and income apportioning changes, as well as several tax expenditures either enacted or amended since the 2012 legislative session. Based on claims data, analysts assumed that the total impacts of the high-wage jobs tax credit (HWJTC) contain substantial non-recurring elements in the first-quarter of FY 16 and added back \$24.4 million to the model results for FY 17 and beyond to account for this. The recurring levels of the construction and the manufacturing deductions from GRT are already reflected in the tax base and, therefore, CREG analysts did not make additional adjustments to the revenue forecast based on these tax expenditures. HWJTC claims were \$21.4 million and \$48.8 million in FY13 and FY14, respectively. Analysts are still somewhat uncertain about the total amounts of HWJTC claims paid during FY 15 and the first quarter of FY 16. During those years the \$50 million Film Production Tax Credit cap was reached.

Selected Tax Law Changes / Tax Expenditures	FY16	FY17	FY18	FY19	FY 20
Rate Reduction and Single-Sales Apportioning (CIT)	-63.3	-93.8	-117.1	-131.5	-135.0
Mandatory Combined Reporting (CIT)	5.8	4.2	3.5	3.5	3.5
High-Wage Jobs Tax Credit	-70.0*	-20.0	-20.0	-20.0	-20.0
Manufacturing Deduction (GRT)	-20.0	-27.2	-37.0	-37.0	-37.0
Construction Deduction (GRT)	-15.6	-13.0	-13.7	-13.7	-13.7
Film Production Tax Credit (CIT)	-50.0	-50.0	-50.0	-50.0	-50.0
Locomotive Fuel Tax Exemption (Comp)	-3.0	-3.1	-3.1	-3.2	-3.3
Total:	-216.1	-202.9	-237.4	-251.9	-255.5

* Does not include amounts of HWJTC claimed against compensating tax. Year-over-year revenues for FY 16:Q1 comp were down by \$21.4 million from FY 15:Q1 (based on TRD's GenTax monthly report).

In addition to the recent changes, TRD has estimated the costs and some of the benefits of extant tax expenditures. In the document, "New Mexico Tax Expenditure Report 2014", TRD lists some 125 tax credits, exemptions or deductions that are commonly agreed to be tax expenditures and a further 19 provisions that are "arguable". Attachment 6 outlines tax expenditures in the referenced document that have a total general fund cost of over \$5,000,000 annually (based on the estimate for FY 13).